

COMMONWEALTH OF MASSACHUSETTS  
DEPARTMENT OF PUBLIC UTILITIES

USGEN NEW ENGLAND, INC.                    )  
NEW ENGLAND POWER COMPANY            )  
MASSACHUSETTS ELECTRIC COMPANY       )  
NANTUCKET ELECTRIC COMPANY            )

DOCKET NO. \_\_97-94

DIRECT TESTIMONY

OF

PAUL F. LEVY

USGen New England, Inc.  
New England Power Company  
Massachusetts Electric Company  
Nantucket Electric Company  
Docket No. \_\_\_\_\_  
Witness: Levy

1 Q. Please give your name, address, and professional qualifications.

2 A. My name is Paul F. Levy. I am Adjunct Professor of Environmental Policy at the  
3 Massachusetts Institute of Technology, 77 Massachusetts Avenue, Cambridge, MA. I  
4 am also an independent consultant offering strategic planning and advice; litigation and  
5 regulatory support; negotiation training and assistance; and arbitration for domestic and  
6 international firms and government in the water, wastewater, energy, and  
7 telecommunications fields.

8 Before joining the MIT faculty, I was Executive Director of the Massachusetts  
9 Water Resources Authority, and previously I was Chairman of the Massachusetts  
10 Department of Public Utilities, a Senior Consultant at Economics and Technology, Inc.,  
11 Director of the Arkansas Energy Department, and Deputy Director of the  
12 Massachusetts Energy Policy Office. A complete resume summarizing these positions  
13 and other activities is included as an appendix to this testimony. I have testified on a  
14 number of occasions before state and federal regulatory bodies, including this  
15 Department.

16

17 Q. Have you been involved in the sale of generating assets undertaken by the New  
18 England Electric System companies?

1 A. Yes, for the last several months, I have been engaged as an advisor to the New England  
2 Electric System companies (“NEES” or “NEES companies”) on this matter. I am  
3 therefore familiar with many of the aspects of the divestiture process as that process  
4 has evolved during this period.

5  
6 Q. What is the purpose of your testimony?

7 A. The purpose of my testimony is to offer my professional opinion that the NEES  
8 divestiture process achieved the goal set forth by the Department in its approval of the  
9 Massachusetts Electric Company (“Mass. Electric”) settlement in January, 1997, and  
10 further is consistent with the public interest, as required by G.L. c. 164, sections 96 and  
11 97.

12  
13 Q. What is your understanding of the Department’s goal in approving the Mass. Electric  
14 settlement?

15 A. After indicating that the Department would “issue an order on the method of the sale  
16 and the reasonableness of the proceeds as part of its plan approval”, the Department  
17 stated that “in this proceeding, the Department and intervenors have expressed the goal  
18 of attaining a market valuation of stranded costs and creating a competitive market.”  
19 Docket D.P.U. 96-25. As I shall discuss below, I believe that the NEES divestiture

1 process has achieved the first goal -- attaining a market valuation of stranded costs --  
2 and in so doing has helped the Commonwealth to achieve the second goal -- creating a  
3 competitive market. In accomplishing these ends, the divestiture process has also  
4 demonstrated that it is consistent with the public interest.

5

6 Q. How would you determine whether the divestiture process resulted in a market  
7 valuation of stranded costs?

8 A. If the process resulted in a market-based price for the assets that were offered for sale,  
9 that price can be used by the Department to determine the level of stranded costs  
10 remaining to be paid by the company's ratepayers.

11

12 Q. What specific criteria would you use to evaluate the divestiture process to determine if  
13 it resulted in a market-based price for the assets that were offered for sale?

14 A. The criteria I would apply are the following:

- 15 1. Was the divestiture process fair to the participants in providing them an  
16 opportunity to obtain pertinent, timely, and equivalent information about the  
17 assets that were being offered for sale?
- 18 2. Was the process for determining the number of qualified bidders reasonably  
19 designed and implemented to yield a fair market valuation?

1           3.       Was the process to decide how the assets would be grouped reasonably  
2                   designed and implemented to yield a fair market valuation?

3           4.       Were the sale terms reasonably developed and clearly presented so as to  
4                   produce a fair market valuation?

5           As I shall discuss, I believe that NEES has met these criteria and has therefore satisfied  
6                   the goal of achieving a market-based price for the assets that were offered for sale.

7

8   Q.       Before turning to your evaluation of the NEES divestiture process, would you please  
9                   discuss any difficulties you see in meeting these criteria during such a process?

10   A.       Yes, the difficulty in achieving these tasks is that, in planning for the auction, one must  
11                   assume that the process can only be carried out once. This is because the cost of  
12                   repeating an auction is high, both for the seller and the bidders. On the seller's side, it  
13                   takes a substantial effort to prepare bid documents, draft purchase contracts, and  
14                   organize the information needed by buyers to evaluate the assets. Likewise, on the  
15                   buyer's side, it takes substantial resources to carefully evaluate the assets being offered  
16                   and to determine what legal and financial arrangements would need to be in place to  
17                   make a purchase feasible and worthwhile. As noted by Mr. Widener, it is reasonable to  
18                   assume that the bidders each spent many hundreds of thousands dollars in preparing  
19                   their bids in this auction.

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1 In addition, if an auction is cancelled after substantial resources have been spent by  
2 potential bidders, highly qualified bidders may choose not to participate in the next one.  
3 For one thing, they may have a heightened fear that the second process, too, will be  
4 interrupted midcourse. For another, they may fear that the seller or other bidders have  
5 learned something about the buyer's preferences that will put them at a disadvantage in  
6 the bidding.

7

8 Q. What are the ramifications of this conclusion?

9 A. The major ramification is that the seller must use its best judgment in real time, i.e.,  
10 before and during the auction process. This judgment must be applied, first, in  
11 planning the auction and preparing its initial design. Equally important, though, the  
12 seller must reflect on the auction process as it occurs, to make adjustments that it  
13 believes will improve the overall result. Adjustments can come from observations  
14 made by the seller as the auction proceeds and also from suggestions made by bidders  
15 as the auction proceeds. Of course, it is extremely important to the auction process  
16 that the seller accurately communicates both the initial auction design and any  
17 adjustments to the bidders in a timely fashion.

18

1 Q. Likewise, before turning to your evaluation of the NEES divestiture process, would  
2 you please discuss any difficulties you see for regulators in evaluating whether a  
3 divestiture process has met the criteria you have set forth?

4 A. Like the seller in the auction, regulators have no “control” group to which they might  
5 compare the sale to see if a better result might have been obtained in a different way.  
6 (Even another utility selling its assets in the same state cannot serve as a control  
7 because the assets vary, the condition of the assets is different, and the timing of the  
8 sale relative to other market events is different.) Therefore, to permit a thorough  
9 regulatory review, the seller must clearly present its approach and the rationale for its  
10 approach to the regulators so that the regulator has the basis to evaluate the  
11 reasonableness of the approach, and the fairness and openness of the sale process and  
12 consistency with the four criteria set forth above.

13

14 Q. Turning now to the first of the criteria you have set forth for evaluating the divestiture  
15 process, please explain why it is important for the divestiture process to be fair to the  
16 participants in providing them an opportunity to obtain pertinent, timely, and equivalent  
17 information about the assets that were being offered for sale.

18 A. There are two reasons this is important. First, if any of the participants in an auction  
19 justifiably believed that they were being discriminated against in the manner in which

1       they were provided information about the assets, they might not choose to participate.  
2       This would limit the number of potentially qualified bidders and reduce the likelihood  
3       of competitive bids. Second, the efficient functioning of any marketplace requires the  
4       free flow of information pertinent to the transactions in that marketplace. The auction  
5       process is a marketplace that relies on the seller to provide a substantial amount of  
6       information about the assets, so that potential bidders have a full understanding of the  
7       characteristics of the assets and are able to conduct their own financial analysis of the  
8       value of those assets.

9               Thus, in an auction situation like that surrounding the disposition of NEES'  
10       assets, fairness requires an equal provision of all relevant information to all potential  
11       bidders. More specifically, the auction process should provide all bidders with the  
12       opportunity to receive comparable information concerning the assets to be sold.

13       Further, this information should be offered to bidders in the same time frame so that  
14       they will have an equal opportunity to consider and analyze it.

15  
16   Q.     Do you believe that the NEES process was fair to the participants in providing them an  
17       opportunity to obtain pertinent, timely, and equivalent information about the assets that  
18       were being offered for sale?



1 A. Yes. As Mr. Jesanis and Mr. Widener discuss in their testimonies, NEES was  
2 meticulous in its presentation of relevant information to the potential bidders. They  
3 explain that NEES ensured an equal provision of all relevant information to all potential  
4 bidders. All bidders had the opportunity to receive comparable information concerning  
5 the assets to be sold. They all had access to the document room in Westborough and  
6 Boston, to the power plants themselves, and to NEES personnel and NEES' agents to  
7 ask questions. Further, Mr. Widener documents that this information was offered to  
8 bidders in the same time frame so that they would have an equal opportunity to  
9 consider and analyze it. The document room was open for review for all bidders during  
10 the same time period. Tours of power plants were scheduled within a few weeks of  
11 each other, permitting comparable views of the facilities (while permitting potential  
12 bidders to avoid each other on the company's property). Access to NEES personnel  
13 and agents was likewise contemporaneous for all potential bidders.

14 Given these facts, I conclude that the company achieved fairness through an  
15 equal provision of all relevant information to all potential bidders.

16

17 Q. Turning to your second criterion, why must there be a reasonable process for  
18 determining the number of qualified bidders to yield a fair market valuation?

1 A. The likelihood of achieving a market-based price requires a determination of the  
2 number of qualified bidders because an auction of the kind involving the NEES assets  
3 has large transaction costs. As Mr. Widener discusses in his testimony, inclusion of too  
4 many bidders will discourage some of the more qualified bidders who might otherwise  
5 have offered higher prices: Some of those bidders would conclude that their odds of  
6 success in the auction would be too low to warrant spending the hundreds of thousands  
7 of dollars needed to carry out a proper due diligence process for the assets in question.  
8 Therefore, a process is needed to pre-qualify bidders.

9  
10 Q. Was NEES' process for determining the number of qualified bidders reasonably  
11 designed and implemented to yield a fair market valuation?

12 A. Yes. As Mr. Widener notes, NEES used a two-stage process to pre-qualify bidders. In  
13 the first, non-binding round of bidding, bidders had to demonstrate a level of financial  
14 ability and stability consistent with the purchase of hundreds of millions of dollars in  
15 assets. By this standard, those bidding in the first round had the financial capability to  
16 purchase assets and therefore were appropriately invited to supply information about  
17 their preferences, information that was valuable to the auction designers.

18 For the second round, bidders were pre-qualified based on their level of  
19 interest, as reflected in the preliminary prices offered in the first round. This permitted

1 NEES to reduce the number of bidders to a level consistent with achieving participation  
2 and serious bids in the second round. Mr. Widener explains this process, too, in his  
3 testimony.

4 In my opinion, the process for determining the number of qualified bidders was  
5 professionally designed and executed and was effective in achieving a market-based  
6 price for the assets.

7  
8 Q. Why, in a multi-asset auction, is it necessary to group the assets appropriately to yield a  
9 fair market valuation?

10 A. In theory, the grouping of assets in an auction is not relevant because groups of buyers  
11 will aggregate themselves in such a manner as to divide the assets among themselves,  
12 optimizing the value for the group as a whole and therefore providing the seller with a  
13 number of reasonable bids. However, in practice, this is not the case, and the  
14 theoretical model does not hold. In practice, there are substantial transaction costs for  
15 potential bidders in a multi-asset auction, both in evaluating the assets themselves and  
16 also in attempting to create purchasing groups to join together to buy groups of assets.  
17 In light of these transaction costs, it is reasonable for the seller to make a judgment as  
18 to the appropriate grouping of assets, in the hope of achieving the best possible auction  
19 results.

1           Given the tension between the individual value of assets and the value of the  
2           assets as a group, or “enterprise”, it is prudent for the seller to engage in a process by  
3           which alternate groupings of assets is tested.

4  
5   Q.    In the NEES auction, was the process used to decide how the assets would be grouped  
6           reasonably designed and implemented to produce a fair market valuation?

7   A.    Yes. Mr. Widener describes in detail the process by which alternate groupings of  
8           assets was tested and why this process was implemented. In the first round of bidding,  
9           bidders were permitted to group assets in the manner deemed most attractive to them,  
10          with no restrictions placed upon the manner in which bidders made proposals. These  
11          preliminary bids were reviewed by the NEES team, and various possible groupings of  
12          assets were analyzed to determine which grouping would be most likely to yield the  
13          maximum value in the next round. The final result of this testing and analysis was that  
14          NEES was able to conclude that some grouping of assets in the second round would be  
15          more likely to produce a fair market valuation.

16                Thus, in the second round, NEES decided to leave open the possibility of  
17                discrete bids for the hydroelectric facilities as one group, and for the fossil units and  
18                IPP contracts as another group, while also allowing bids on the entire enterprise. This

1           was a reasonable conclusion based on the first round of bidding. Therefore, I conclude  
2           that NEES has met this criterion as well.

3

4    Q.     Turning to your final criterion, why is it important to have reasonable and clearly  
5           developed sale terms to produce a fair market valuation?

6    A.     There are a number of business factors that can influence the bids on assets of the sort  
7           being sold by NEES. In addition to a multitude of highly technical legal, accounting,  
8           and operational provisions, there are several major policy-related sale terms that are  
9           important. These include the assignment of environmental liabilities, the treatment of  
10          current labor agreements, and the determination of local property taxes. All of these  
11          factors can have a large financial impact on the new owner of the facilities, and it is  
12          incumbent on the seller to make clear how these costs will be assigned or determined  
13          upon the sale of the assets.

14                 For example, to achieve a market-based price, it is appropriate and necessary  
15                 for the seller to be explicit about the assignment of environmental liabilities. Likewise,  
16                 sale terms related to labor costs, benefits, and work rules will have a significant impact  
17                 on buyers' evaluation of power plant assets, as will the property taxes that might be  
18                 imposed on those facilities. These items represent a substantial portion of the recurring  
19                 operating costs of a power plant and therefore must be considered by potential buyers

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1 in their bid preparations. As in the case of environmental liability, potential buyers will  
2 value the certainty that can be provided by the seller in these matters. Absent that  
3 certainty, one would expect at least some of the bidders to discount the bids they  
4 would otherwise submit, as a way of hedging their bets against what they envision  
5 might be the worst case. This understandably risk-averse behavior would reduce the  
6 likelihood of receiving bids that truly reflect market-based prices.

7 Further, the auction process should be designed to permit bidders an  
8 opportunity to comment on whether the seller has adequately specified or resolved  
9 these issues. The auction process is a two-way learning experience. Comments from  
10 potential bidders can be used by the seller to maximize the value received through the  
11 auction. It might be that potential bidders, for example, have informed the seller that  
12 they view a certain environmental issue as having a high risk; but the seller might have  
13 a different perception of that risk and might have assigned a lower value to it than the  
14 sellers. The seller might react to this information by changing the terms of the auction  
15 to shift the perceived risk away from the buyers and onto itself, creating value for the  
16 buyers that will be reflected in their bids, while absorbing a risk of lesser import to  
17 itself.

1 Q. In the NEES auction, were the sale terms reasonably and clearly developed so as to  
2 produce a fair market valuation?

3 A. Yes, in addition to legal, accounting, and operational provisions, the major factors I  
4 have discussed -- the assignment of environmental liabilities, the treatment of labor  
5 costs and property taxes -- were clearly stated.

6 Further, as noted by Mr. Widener, the auction process was designed to permit  
7 bidders an opportunity to comment on whether the seller has adequately specified or  
8 resolved these issues. This was possible in a general way throughout the auction  
9 because open lines of communication were maintained between NEES and the potential  
10 bidders. This communication was also possible because the specific contractual  
11 documents were offered to the bidders, and they were permitted to note exceptions.  
12 Accordingly, I believe that NEES has demonstrated that it has satisfied this criterion, as  
13 well, in achieving a market-based price for its assets.

14

15 Q. You have also made the general observation that a seller must use its best judgment in  
16 real time, i.e., before and during the auction process. In addition to meeting the  
17 specific criteria outline above, do you believe that NEES did so?

18 A. Yes, I believe that NEES devoted extraordinary resources to the divestiture process  
19 and was therefore able to apply its best judgment, both in planning the auction and

1 preparing its initial design and in reflecting on the process as it occurred, to make  
2 adjustments that it believed would improve the overall value of the auction to its  
3 customers. Adjustments were made as a result of NEES' own observations and in  
4 response to suggestions made by bidders as the auction proceeded. Further, NEES  
5 communicated both the initial auction design and adjustments to the bidders in a timely  
6 fashion.

7  
8 Q. What is your general conclusion about the NEES divestiture process?

9 A. In light of my comments above, I believe that NEES has clearly demonstrated that it  
10 carried out a process that resulted in a market-based price for the assets that were  
11 offered for sale, thereby permitting the Department to satisfy its goal of obtaining a  
12 market valuation of stranded costs.

13  
14 Q. Beyond this conclusion, why do you conclude that the divestiture meets the public  
15 interest standard set forth in the General Laws?

16 A. In short, the sale will have a positive effect on the implementation of the state policy of  
17 retail competition, a policy found by the Department to be consistent with the public  
18 interest.

19



1 Q. How would you describe the positive effect of the divestiture on the implementation of  
2 the state policy of retail competition?

3 A. In its Orders, the Department has recognized the value of divestiture in establishing a  
4 positive environment for retail competition. Divestiture offers the clearest possible  
5 proof of mitigation of stranded costs and quantifies, without burdensome administrative  
6 proceedings, the amount of such costs that will be collected through access charges. It  
7 also provides a clean, clear, and unambiguous method for resolving the issue of affiliate  
8 transactions and standards of conduct among the distribution, transmission, and  
9 generation sections of an integrated utility company. The NEES divestiture process  
10 accomplishes these results and therefore is consistent with the public interest.

11

12 Q. Are there other ramifications of the NEES divestiture process that support its being  
13 consistent with the public interest?

14 A. Yes, the NEES sale also offers a bonus that will help stimulate retail competition,  
15 particularly in the early days of restructuring. Assuming that retail access is broadly  
16 available in New England and no holdback applies, the bid received by NEES from  
17 USGen means that, overall, customer's electric bills under the standard offer service  
18 will decrease 18 percent, (as explained in Mr. Zschokke's testimony). Because the  
19 implementation of the lower access charge eliminates the necessity for any deferral of

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1 Mass. Electric's standard offer costs, the sale is likely to stimulate more people to  
2 move off of the standard offer in the first year and into the competitive marketplace.  
3

4 Q. Please explain why this is likely to occur.

5 A. Under the terms of the settlement agreement approved by the Department, the standard  
6 offer service provided to Mass Electric customers will be priced at 3.2 cents rather than  
7 the previously expected 2.8 cents in the first year, while the access charge will be  
8 reduced from 2.8 to 1.5 cents assuming that retail access is broadly available and 1.9  
9 cents if it is not. Under either circumstance, the portion of the bill for which there is  
10 competition will provide more opportunity, in percentage terms, for power suppliers to  
11 demonstrate their competitive advantage over the standard offer. It is reasonable to  
12 expect that this result will stimulate a greater number of customers to choose a power  
13 supplier rather than relying on the standard offer, thus speeding the rate at which retail  
14 choice will be embraced by individual customers in the Commonwealth.